MESA PETROLEUM CO.

ANNUAL REPORT 1970

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MESA PETROLEUM CO.

contents

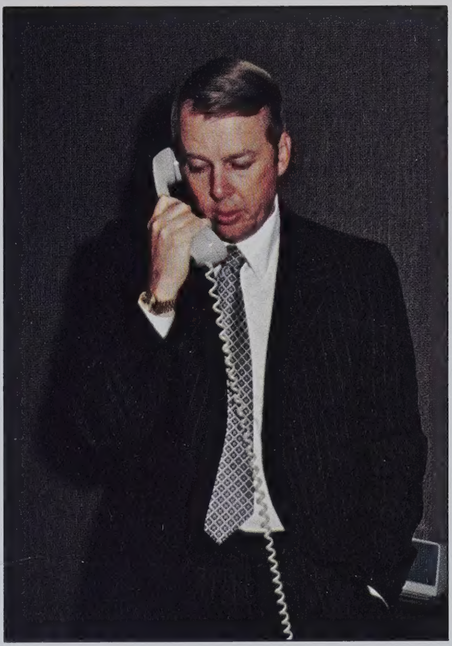
The Zapata Norness INTREPID, currently drilling on Eugene Island Block 330, offshore Louisiana.

HIGHLIGHTS

	1970	1969	1968	1967	1966
FINANCIAL					
Revenues	$47,362,000	$26,957,000	$16,404,000	$16,214,000	$14,178,000
Cash flow, excluding extraordinary items	$ 9,443,000	$ 9,487,000	$ 7,066,000	$ 6,555,000	$ 5,425,000
Income before extraordinary items	$ 6,939,000	$ 8,257,000	$ 6,034,000	$ 5,521,000	$ 4,653,000
Net income	$ 6,685,000	$ 8,531,000	$ 6,220,000	$ 5,841,000	$ 4,653,000
Earnings per common and common equivalent share before extraordinary items	$1.76	$2.14	$1.56	$1.40	$1.21
Total assets	$83,216,000	$78,236,000	$34,231,000	$29,701,000	$22,978,000
Stockholders' investment	$32,915,000	$27,806,000	$15,540,000	$21,462,000	$15,749,000
OPERATING					
Net production					
Oil and condensate (bbls.)	390,634	337,449	353,561	328,767	251,720
Natural gas liquids (bbls.)	688,041	688,932	701,576	605,702	588,053
Natural gas (mcf.)	52,264,063	48,225,652	45,137,679	45,969,085	41,217,326
Non-producing acreage					
Gross acres	4,229,513	4,058,725	3,456,688	1,955,253	1,106,482
Net acres	2,118,941	2,237,325	1,783,314	838,618	792,262

Drilling operation in a southern Louisiana marsh.

TO OUR SHAREHOLDERS



Dear Shareholder:

The year 1970 was one of transition and consolidation, wherein Mesa added to its executive leadership and exploratory staff, expanded its production facilities, and significantly enhanced the quality of its oil and gas acreage position. Mesa continues to emphasize and actively explore areas where large accumulations of oil and gas reserves can be found. Management initiated several exploratory projects which, if successful, could materially enhance the company's long-term growth. Developments domestically and throughout the world have created an inadequate and undependable supply of energy during a period of steadily increasing demand. We believe that this energy shortage will cause the rewards of exploration to be increased to a level more commensurate with the risks.

Results of Operations

Gross revenues for the year ended December 31, 1970 increased to $47,361,550, from $26,957,172 for the comparable period in 1969. Net income for 1970 was $6,938,845, excluding extraordinary items, compared to $8,257,375 in 1969. Per share earnings were $1.76 compared to $2.14 on a fully-diluted basis and excluding extraordinary items. The large increase in gross revenues is a result of sales generated by our Agro division, acquired in 1969. The reduction in net income was due primarily to higher interest costs, decreased emphasis on drilling arrangements, and depressed margins in our cattle feeding operation. It should be noted that under the take-or-pay provision of our gas sales contract with The Kansas Power & Light Company, Mesa received a payment of $1,155,245 which has been reflected as deferred income for financial reporting purposes. This deferred credit will be reported as income as the gas is taken by KP&L.

Personnel

Mesa's management group was expanded due to increased exploration and production activities. Frank R. Davis, Vice President in charge of drilling and producing operations, joined Mesa after twenty-one years experience in the petroleum industry. James O. Upchurch, initially employed by Mesa in 1969, was promoted to Vice President in charge of engineering. Mr. Upchurch has over twenty years experience in petroleum and chemical engineering. Our exploration staff was strengthened during the year by the addition of two geophysicists, one geologist, and one engineer. These individuals are all experienced personnel capable of making significant contributions to the growth of our company.

Exploration and Development

During 1970, we acquired substantial acreage in the offshore areas of Louisiana and Texas, and in the North Sea. In Canada, we continue our extensive seismic programs, acreage acquisitions, and exploratory drilling. In the Mid-Continent, emphasis is placed on the interpretation of data relating to the deep Anadarko Basin. In the Rocky Mountain region, we have been concentrating on structural evaluations in the Williston Basin and stratigraphic projects in Central Montana.

Production

In May, 1970, a twenty-year intrastate gas sales contract, which replaced two existing contracts, was executed between Mesa and The Kansas Power & Light Company. Under the terms of

this contract, the volume of gas to be sold to KP&L over the twenty-year period represents a value in excess of $300 million. The increased deliveries to KP&L began during the latter part of the fourth quarter. To process this larger quantity of gas, additional facilities were constructed at Mesa's gas processing plant near Ulysses, Kansas. As a result of this construction, completed in February, 1971, our recovery and sales of plant products will more than double. All of the company's exploration and production divisions reported increases in oil and gas sales during 1970.

Agribusiness

The Agro division continued to operate profitably in 1970, despite an unfavorable economic environment and a generally depressed fat cattle market during the first half. However, conditions improved during the second half, and the number of cattle in our lots reached an all-time high of 93,000 head in the fourth quarter. Recent developments in the national economy, along with increases in fat cattle prices, should provide further improvements in our cattle feeding operation during 1971.

Financial

In July, 1970, Mesa negotiated a private placement of $10 million of 9¼% fifteen-year mortgage notes with four institutional lenders. This loan was arranged early in 1970 in order to facilitate Mesa's participation in the Federal lease sale for offshore Louisiana, which was not held until December 15, 1970. The first draw-down of $7 million was completed in January, 1971, with the remaining $3 million to be obtained on April 1. These notes carry warrants for the purchase of 100,000 shares of Mesa common stock at $33 per share. On December 1, 1970, we consummated a five-year secured bank loan of $5.5 million, part of which was used for the addition to our Ulysses gas processing plant. The remainder of the proceeds from the loan was added to working capital.

Other Activities

On December 31, 1969, Mesa filed a Registration Statement with the Securities and Exchange Commission outlining the terms of a proposed exchange offer to the stockholders of Southland Royalty Company. Mesa had previously purchased approximately 12 per cent of Southland's outstanding common stock at $45 per share. On April 15, 1970, Mesa announced that it would not proceed with the exchange offer and subsequently withdrew its pending Registration Statement. On February 17, 1971, Mesa sold the Southland stock at a net price to Mesa of $45.0825 per share. The bulk of the proceeds were applied to repayment of indebtedness incurred in connection with the purchase. This transaction has been reflected in the financial statements as of December 31, 1970.

The foregoing are the highlights of Mesa's operations for the calendar year 1970. The following pages will give you a more detailed summary of events.

Sincerely,

TB Pickens Jr.

T. B. PICKENS, JR.
President and Chairman of the Board

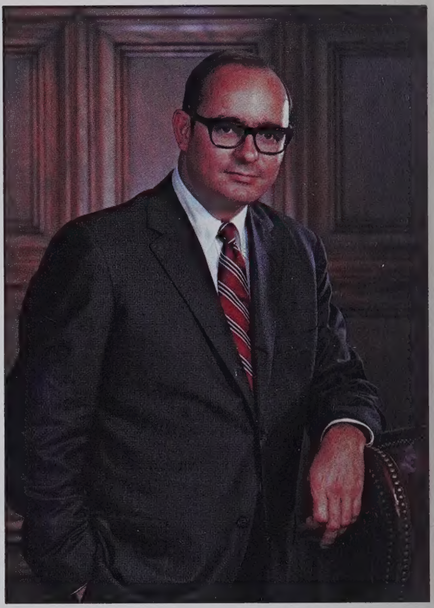
March 15, 1971

Seismic crew at work in the foothills of Alberta.

DIRECTORS

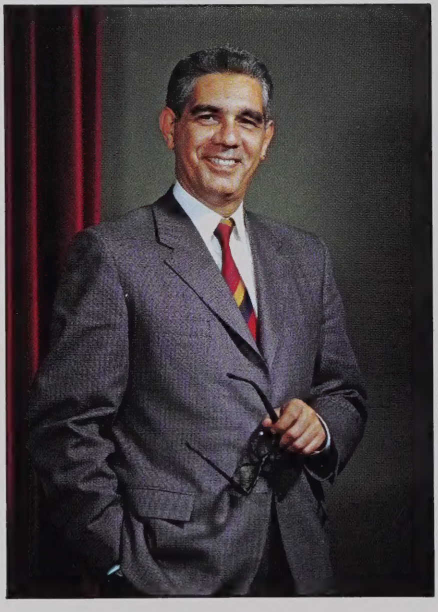
Experienced and knowledgeable leadership is the backbone of any company where growth and expansion are the primary goals. We feel that an aggressive and talented management team backed by skilled leadership both within and outside the Company creates a situation ideally suited for the decision-making process. We believe that Mesa's management meets such criteria.

LESTER A. ANDERSON



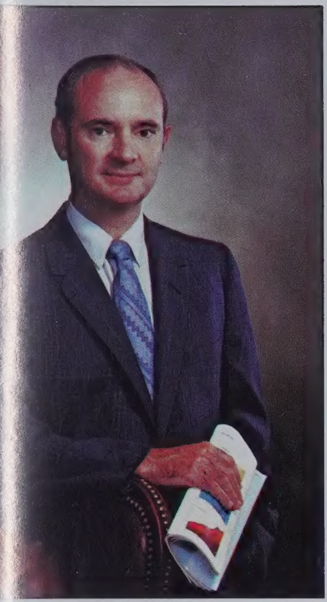
JOHN D. KIRKLAND

MICHAEL A. NICOLAIS



T. B. PICKENS, JR.

RICHARD S. SMITH



ES H. MADDEN, JR.

BERT L. STILLWELL

Board of Directors:

LESTER A. ANDERSON

Mr. Anderson has had forty-seven years experience in the oil and gas industry. Before his retirement in 1969, Mr. Anderson was Vice President of Hugoton Production Company.

JOHN D. KIRKLAND

Mr. Kirkland has twelve years experience in the field of corporate finance. He is currently Group Vice President of Finance with Pennzoil United, Inc.

WALES H. MADDEN, JR.

A director of Mesa Petroleum Co. since 1964, Mr. Madden was recently appointed Chairman of the Executive Committee. He is a partner in the Amarillo law firm of Selecman and Madden.

MICHAEL A. NICOLAIS

A director since Mesa's acquisition of Hugoton Production Company in 1969, Mr. Nicolais has twenty-three years experience in the corporate management field. He is currently President of The Clark Estates.

T. B. PICKENS, JR.

Mr. Pickens brings to the Company twenty years experience in the oil and gas business. He has been President and Chairman of the Board of Mesa since its organization in 1964.

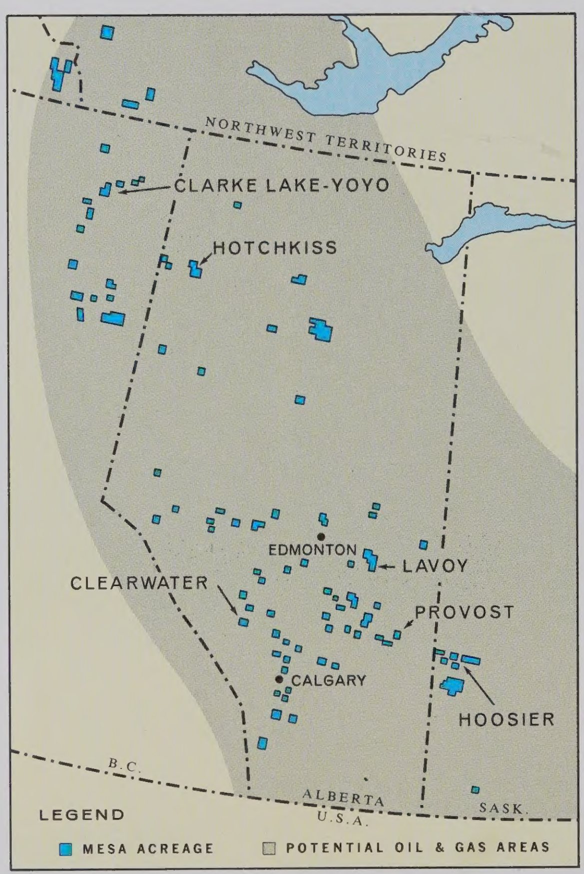
RICHARD S. SMITH

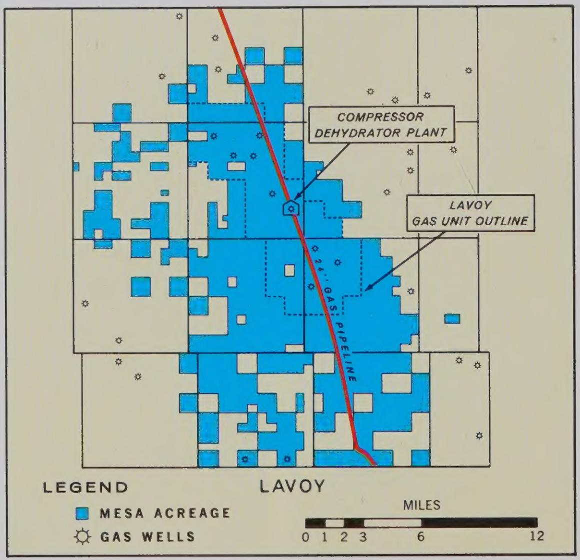
Mr. Smith is an officer in the investment banking firm of New York Securities Co., Inc., and has been a director of Mesa since 1968.

ROBERT L. STILLWELL

Mr. Stillwell is a partner in the Houston law firm of Baker & Botts. He has ten years experience in corporate law and presently serves as Mesa's corporate counsel. He has served on our Board of Directors since 1969.

EXPLORATION AND DEVELOPMENT





We continue to direct our exploration program toward originating and developing prospects in selected areas of the divisions in which we operate. This provides high grade prospects with greater flexibility in drilling. In addition to our near term exploration objectives, we have acquired acreage in promising wildcat areas where costs are reasonable and geologic conditions are favorable.

The following table reflects the geographical distribution of our acreage including leases, drilling permits, and petroleum and natural gas reservations:

Area	*Net Acres*
Western Canada and Alaska	1,823,000
United Kingdom	502,000
Mid-Continent	146,000
Rocky Mountains	262,000
Gulf Coast	50,000
Total	2,783,000

canada

In this large and very prospective area, we have concentrated much of our effort in geologic and seismic work searching for Devonian reefs. This method has proved successful in outlining reefs, although the evidence is often subtle and gives no indication of the reef's rock quality or the presence of hydrocarbons.

On the plains of eastern Alberta, at Lavoy, we have completed nine gas wells at depths of approximately 2,500 feet and have formed a 30,000 acre gas unit with assigned reserves of 52 billion cubic feet. Gathering and production facilities were completed and sales of over 6 million cubic feet per day commenced in February, 1971. Mesa's net interest in this unit is 76 per cent; in addition, we own 83,000 acres in the immediate area where we continue to explore.

Exploration in the Northwest Territories has been accelerated by several companies. Mesa holds a large position in this prospective area and is currently participating in a reconnaissance seismic survey along the Mackenzie River Valley.

At Clearwater, in the foothills 80 miles northwest of Calgary, we acquired an option on 60,000 acres of coal permits. This area is easily accessible and is being actively explored by several companies for the development of coking coal. Initial evaluation of our permits involving surface geology, core drilling, and analysis of coal samples is presently underway.

united kingdom

A wholly-owned subsidiary, Mesa Eastern, Inc., was formed in 1970 for exploration in the United Kingdom. With Pennzoil United, Inc. and Ulster Petroleums Ltd. as partners, we will participate in the drilling of a test well onshore in southern England as an initial step toward earning a one-third interest in 1.3 million acres. The drilling of this well, originally scheduled in November, 1970, was postponed due to difficulties in obtaining the necessary permits. These permits were obtained and operations commenced on March 5, 1971.

During 1970, Mesa and several partners were awarded licenses in three separate areas of the United Kingdom sector of the North Sea. Our interest in the three licenses is 25 per cent. One of the licenses is in the Median area and consists of two tracts, 21/15 and 22/16, totaling 112,000 acres. We have completed extensive seismic work on these tracts in order to determine how our acreage relates structurally to two recent discoveries in the area by the Amoco Group and British Petroleum. The Amoco Group discovery, 8 miles to the east of Mesa's Block 22/16, flowed 2,160 barrels per day of sweet 39° gravity oil, while the discovery by British Petroleum, 4 miles north of our Block 21/15, tested 4,700 barrels per day of sweet 37° gravity oil. Our second license is in the Moray Firth area, near the Scottish coast. The two tracts included in the license, 12/25 and 19/1, cover a total of 110,000 acres. This acreage is in a sedimentary basin of Cretaceous age, where shows of oil and gas have been reported in the few test wells drilled in the area. We will continue geologic studies and will conduct a seismic program on these

two tracts in 1971. Our third license is in the Humber area and is composed of two tracts, 46/5 and 46/10, totaling 48,000 acres. This acreage is in an area of both stratigraphic and structural entrapment of gas. Geologic studies will be conducted on this acreage during the next twelve months. These licenses bear a one-eighth royalty and require certain work obligations, including the drilling of a test well prior to the end of the six year exploratory period.

The recent discovery of large oil accumulations in the North Sea has revived the interest of the industry, and competition for new licenses in the area will be intense. We shall continue to collect data in order to be prepared to file on additional acreage. A political administration which encourages the spending of funds for exploration rather than for the right to explore, the insatiable demand of an immediate market, and the confirmed presence of commercial oil and gas, make this an attractive exploratory area.

mid-continent

The primary effort of this division is directed toward locating prospects for Hunton gas production in the Anadarko Basin, where Mesa owns leases in several prospective areas. We have accelerated our exploratory activity in the deeper portion of this basin due to recent discoveries of large reserves and increases in the well-head price for gas.

In late 1970, we extended the Hemphill Granite Wash Field in the Texas Panhandle with a well which tested 18 million cubic feet of gas per day, plus 40 barrels of condensate per million cubic feet. We expect to drill several development wells in this field during 1971. Mesa's net interest in 1120 acres is 79 per cent.

rocky mountain

In the Williston Basin of Montana and North Dakota, we are directing our exploratory work toward seismic evaluation of acreage in geologically favorable trends for Nisku and Red River production. In central Montana, we are searching for oil in the Tyler sands where geologic studies indicate stratigraphic trapping possibilities over a large area.

In the Green River Basin of Wyoming, we acquired some 20,000 acres favorably located for stratigraphic entrapment of gas in multiple sands. We expect drilling activity in this area during 1971.

gulf coast

In December, at the Federal lease sale for offshore Louisiana, 127 tracts were offered containing 600,000 acres. The competition was intense from both major companies and independents. Mesa, as a member of a four-company combine, joined in bidding on 37 of these tracts and exposed a total of $40 million. We were successful in obtaining varying interests in five of the tracts with a total expenditure of approximately $10 million. Mesa's interest in each of the five tracts is summarized below:

(1) Block 330 Eugene Island — Mesa owns a 5% interest in this 5,000 acre tract at a net cost of $1,413,984.

(2) Block 228 Vermilion — Mesa owns a 41.5% interest in this 5,000 acre tract at a net cost of $1,489,405.

(3) Block 270 East Cameron — Mesa owns a 5% interest in this 2,500 acre tract at a net cost of $1,609,349.

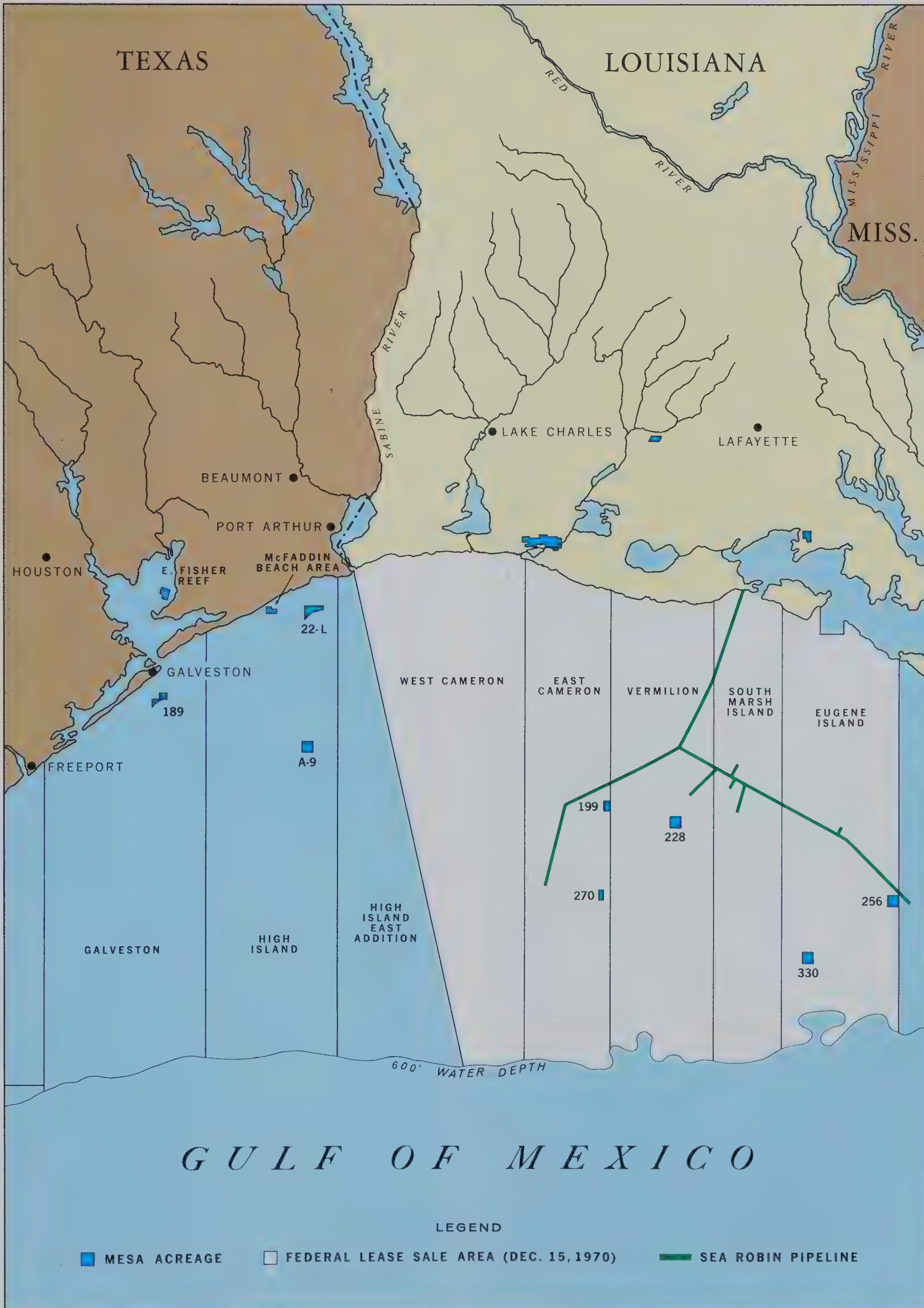
(4) Block 256 Eugene Island — Mesa owns a 30.77% interest in this 5,000 acre tract at a net cost of $4,972,364.

(5) Block 199 East Cameron — Mesa owns a 28.89% interest in this 1,609.07 acre tract at a net cost of $612,265.

These leases are in the Plio-Pleistocene trend on seismic structures in waters ranging from 100 to 240 feet in depth. Two drilling rigs are under contract, and testing of these tracts was commenced in early February.

In the Galveston and High Island areas of offshore Texas, we acquired a 100 per cent interest in a total of 8,770 acres on three potential gas prospects. The tracts were acquired in State lease sales held in 1970. We plan to commence testing this acreage, located in water depths from 15 to 45 feet, during 1971.

Onshore in this division, we are finalizing plans to test three potential gas prospects; one in Texas and two in south Louisiana. Our interest in this acreage varies from 33⅓ to 100 per cent. We continue to acquire prospective leases both in this mature area where deeper and step-out exploration often reveals profitable reserves, and in the Jurassic trend of Mississippi, Alabama, and Florida where wildcatting by others in recent months has been very successful.


TEXAS
LOUISIANA
MISS.
RED RIVER
MISSISSIPPI RIVER
SABINE RIVER
LAKE CHARLES
LAFAYETTE
BEAUMONT
PORT ARTHUR
HOUSTON
E. FISHER REEF
McFADDIN BEACH AREA
22-L
GALVESTON
189
A-9
FREEPORT
WEST CAMERON
EAST CAMERON
VERMILION
SOUTH MARSH ISLAND
EUGENE ISLAND
199
228
270
256
330
GALVESTON
HIGH ISLAND
HIGH ISLAND EAST ADDITION
600' WATER DEPTH
GULF OF MEXICO
LEGEND
MESA ACREAGE
FEDERAL LEASE SALE AREA (DEC. 15, 1970)
SEA ROBIN PIPELINE

PRODUCTION

Completion operations at Lavoy.

Additions to Mesa's gas processing plant.

During 1970, Mesa's daily average net production was 143,189 million cubic feet of gas and 2,976 barrels of oil and natural gas liquids, an increase over 1969 of 7.8 per cent and 4.9 per cent, respectively.

In Canada, the unitization of the Hoosier Field in Saskatchewan has recently been completed and water injection operations have been initiated. Engineering calculations indicate that an increase in production from secondary recovery operations will be realized during the latter part of 1971. Mesa's net interest in this 23 well unit is 43 per cent. The total production from the unit averaged 760 barrels of oil per day in 1970. In the Lavoy area of Alberta, Mesa has a 76 per cent net interest in nine gas wells. Gathering, dehydration, and compression facilities have been completed and production commenced in February, 1971, at a rate of approximately 6 million cubic feet of gas per day.

An intrastate gas sales contract between Mesa and The Kansas Power & Light Company was executed during 1970, which requires KP&L to take 96 per cent of Mesa's allowable production from the dedicated properties in the Hugoton Field up to 70.6 billion cubic feet annually, an increase of 41 per cent over the 1970 requirement. In order to handle these additional purchases, it was necessary for KP&L to increase its existing compression facilities. An addition was completed in December, 1970, and sales to KP&L are now averaging 200 million cubic feet of gas per day. The weighted average price for this gas in 1971 will be 21.3¢ per thousand cubic feet.

The addition to our Ulysses gas processing plant was completed in February, 1971. The recovery of natural gas liquids from the increased volumes of gas sold to KP&L will total approximately 170,000 gallons per day, compared to 80,000 gallons per day in 1970. Under the terms of a new contract with Cities Service Oil Company effective January 1, 1971, the liquids from the Ulysses plant will be delivered to Cities' Hutchinson, Kansas plant for fractionation and sales.

AGRIBUSINESS

The Mesa Agro division operated profitably during 1970, although national and local factors had a detrimental effect on operating results. Higher interest rates and rising prices for feeder cattle and grain contributed to increased costs at a time when the national economic conditions were forcing fat cattle prices lower. These factors, together with increased feedlot capacity in the Panhandle area, caused a reduction in the profitability of this division.

Feedlot and Grain Operations

As a result of the problems which affected the entire cattle feeding industry, the number of cattle in our feedlots declined, and by the end of the second quarter was at a yearly low of 58,000 head, 53 per cent of total capacity. In the third quarter, the number of cattle in the lots steadily increased, and during the fourth quarter reached a peak of 93,000 head, or 84 per cent of capacity. Improved activity during the second half of 1970 resulted in an average capacity utilization for the year of 75,000 head, 68 per cent of total capacity. The number of cattle fed in our feedlots during 1970 totaled 180,000 head. Our elevators and grain storage facilities continue to support our two feedlots. The grain operations were profitable and provided a readily accessible supply for our cattle feeding facilities. The availability of this grain supply in the immediate feedlot area insures greater flexibility for our feedlot customers.

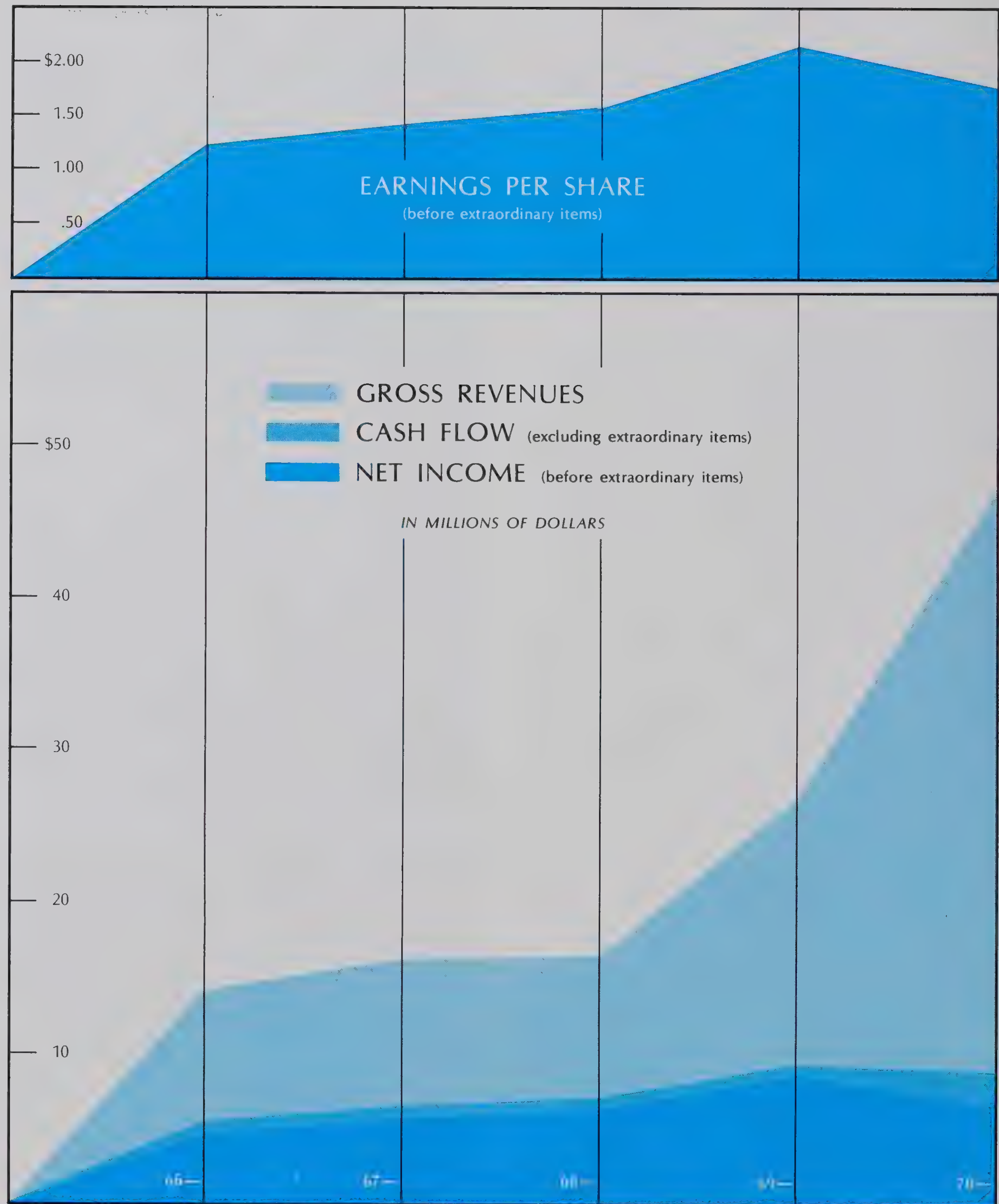
Cattle Operations

The Central Cattle Company division supplies feedlot customers with cattle of excellent quality and condition, both from the Texas Panhandle and from other cattle producing areas in the United States. Central purchases cattle ranging in weight from 250 to 450 pounds and grazes them on wheat or pasture land until they reach approximately 550 pounds. At that time they are either sold to feedlot customers or fed by Central for its own account. During 1970, the number of Company-owned cattle on feed averaged 14,000 head per day, or approximately 19 percent of the average daily utilization of capacity for the feedlots.

Pen riders make health checks twice daily.

A portion of Central's 66,000 acre backgrounding operation.

Mesa Agro's grain storage facilities at Happy, Texas.


$2.00
1.50
1.00
.50
EARNINGS PER SHARE
(before extraordinary items)
GROSS REVENUES
CASH FLOW (excluding extraordinary items)
NET INCOME (before extraordinary items)
IN MILLIONS OF DOLLARS
$50
40
30
20
10
66
67

Consolidated Statements of Income

For the Years Ended December 31, 1970 and 1969

	1970	1969
REVENUES:		
Natural gas and oil sales	$11,195,207	$10,449,986
Products extracted from natural gas	1,414,377	1,184,216
Proceeds from drilling arrangements and sales of oil and gas leases held for resale	1,146,908	3,231,920
Feed, grain, and cattle operations	32,658,643	11,476,881
Gilsonite sales, dividends, and other income	946,415	614,169
	$47,361,550	$26,957,172
EXPENSES:		
Operating expenses and royalties	$ 3,411,136	$ 3,013,120
Cost of drilling arrangements and sales of oil and gas leases held for resale	749,931	1,856,752
Cost of feed, grain, and cattle operations	30,341,353	10,030,566
General and administrative	1,688,924	1,311,865
Interest	3,527,592	1,258,176
Depreciation, depletion, and amortization (Note 2)	1,932,259	1,229,318
	$41,651,195	$18,699,797
INCOME BEFORE FEDERAL INCOME TAXES AND EXTRAORDINARY ITEMS	$ 5,710,355	$ 8,257,375
FEDERAL INCOME TAXES (Note 3):		
Current	(1,800,990)	—
Deferred	572,500	—
INCOME BEFORE EXTRAORDINARY ITEMS	$ 6,938,845	$ 8,257,375
EXTRAORDINARY ITEMS, net of applicable taxes (Note 9)	(254,312)	273,908
NET INCOME	$ 6,684,533	$ 8,531,283
EARNINGS PER COMMON AND COMMON EQUIVALENT SHARE (Note 10):		
Income before extraordinary items	$1.76	$2.14
Extraordinary items	(.06)	.07
Net income	$1.70	$2.21

(See accompanying notes to financial statements.)

Consolidated Balance Sheets

December 31, 1970 and 1969

Assets

	1970	1969
CURRENT ASSETS:		
Cash	$ 1,007,701	$ 2,512,767
Marketable securities, at cost	—	1,355,765
Accounts receivable	5,897,412	4,807,830
Receivable from the sale of investment in Southland Royalty Company, net of applicable debt (Note 11)	1,532,450	—
Estimated federal income tax refund (Note 3)	2,176,163	—
Inventories, at cost which is not in excess of market —		
Oil and gas leases held for resale within one year	233,740	1,538,262
Grain, feed, and cattle (Note 4)	5,581,851	7,470,582
Other	249,595	137,230
Prepaid expenses	222,566	115,619
Total current assets	$16,901,478	$17,938,055
INVESTMENTS, at cost:		
Southland Royalty Company (Note 11)	$ —	$15,254,373
Other	1,456,670	1,494,684
	$ 1,456,670	$16,749,057
PROPERTY, PLANT AND EQUIPMENT, at cost (Notes 2 and 4):		
Plant, producing and nonproducing oil and gas leases, wells and equipment	$58,047,029	$36,412,064
Grain and cattle feeding facilities	6,573,698	6,401,166
Gilsonite mining properties, plant, and equipment	1,443,092	1,299,761
Automotive, office, and other properties	1,410,524	859,985
	$67,474,343	$44,972,976
Less — Accumulated depreciation, depletion, and amortization	10,285,926	8,588,849
	$57,188,417	$36,384,127
EXCESS OF COST OF COMPANIES ACQUIRED OVER EQUITY IN NET TANGIBLE ASSETS AT DATE OF ACQUISITION, not being amortized	$ 6,266,987	$ 6,078,065
DEFERRED CHARGES AND OTHER ASSETS:		
Issue expense on long-term debt, being amortized	$ 973,135	$ 747,259
Deposits and deferred charges	235,152	184,016
Cash surrender value of life insurance	194,100	155,768
	$ 1,402,387	$ 1,087,043
	$83,215,939	$78,236,347

(See accompanying notes to financial statements.)

Liabilities

	1970	1969
CURRENT LIABILITIES:		
Current maturities on long-term debt	$ 3,459,976	$ 2,242,227
Short-term notes payable (Note 4)	3,095,000	5,538,500
Accounts payable and accrued liabilities	5,535,276	7,912,173
Reserve for possible refund (Note 7)	430,000	430,000
Accrued federal income taxes (Note 3)	1,275,535	726,035
Total current liabilities	$13,795,787	$16,848,935
LONG-TERM DEBT, net of current maturities (Note 4)	$35,175,353	$33,581,563
DEFERRED INCOME, advances on gas to be delivered in the future	$ 1,155,245	$ —
DEFERRED FEDERAL INCOME TAXES	$ 174,223	$ —
STOCKHOLDERS' INVESTMENT (Notes 5 and 8):		
Preferred stock, $1 par value, issuable in series, 5,000,000 shares authorized —		
$2.20 cumulative convertible senior preferred stock, issued 682,050 and 851,110 shares, respectively (liquidating preference of $51,153,750 at December 31, 1970)	$ 682,050	$ 851,110
$2.20 cumulative convertible preferred stock, issued 89,772 and 163,376 shares, respectively (liquidating preference of $6,732,900 at December 31, 1970)	89,772	163,376
Common stock, $1 par value, authorized 5,000,000 shares; issued 2,535,368 and 2,070,052 shares, respectively	2,535,368	2,070,052
Warrants to purchase 91,000 and 49,000 shares of common stock, respectively (Note 4)	591,500	318,500
Capital surplus	11,744,286	11,810,969
Reinvested earnings (Note 6)	17,272,355	12,662,068
Treasury stock	—	(70,226)
	$32,915,331	$27,805,849
	$83,215,939	$78,236,347

(See accompanying notes to financial statements.)

Consolidated Statements of Reinvested Earnings and Capital Surplus

For the Years Ended December 31, 1970 and 1969

	1970	1969
REINVESTED EARNINGS:		
Balance, beginning of year	$12,662,068	$ 7,123,871
Net income	6,684,533	8,531,283
Cash dividends —		
Common stock	(246,771)	(162,445)
Preferred stocks	(1,827,475)	(1,913,974)
Predecessor company prior to merger	—	(916,667)
Balance, end of year (Note 6)	$17,272,355	$12,662,068

	1970	1969
CAPITAL SURPLUS:		
Balance, beginning of year	$11,810,969	$ 4,634,967
Stock options exercised (Note 8)	(13,866)	1,999
Conversion of preferred stocks	(218,191)	(354,819)
Expenses incurred in connection with merger in 1969, treated as a pooling of interests	(18,442)	(497,799)
Excess of market value over par value of common stock issued for companies acquired in 1969 (Note 1)	183,816	8,129,184
Retirement of $2.20 preferred stock acquired in 1969	—	(102,563)
Balance, end of year	$11,744,286	$11,810,969

(See accompanying notes to financial statements.)

Consolidated Statement of Source and Use of Funds

For the Years Ended December 31, 1970 and 1969

	1970	1969
FUNDS WERE OBTAINED FROM:		
Net income	$ 6,684,533	$ 8,531,283
Depreciation, depletion, and amortization	1,932,259	1,229,318
Deferred federal income taxes	174,223	—
Funds obtained from operations	$ 8,791,015	$ 9,760,601
Fair value of common stock issued for companies acquired in 1969	183,816	8,189,039
Advances on gas to be delivered in the future	1,155,245	—
Proceeds from sale of investment in Southland Royalty Company	15,273,680	—
Long-term borrowings	21,102,606	20,461,978
Short-term notes payable, refinanced in January, 1970	—	5,538,500
Fair value of warrants to purchase 42,000 and 49,000 shares of common stock, respectively, issued in connection with Series "A" notes	273,000	318,500
Proceeds from exercise of stock options	67,115	2,124
	$46,846,477	$44,270,742
FUNDS WERE USED FOR:		
Capital expenditures, net of retirements—		
Oil and gas properties	$21,919,092	$10,290,485
Feed, grain, and cattle facilities	172,532	12,479,231
Other properties	644,925	625,873
Retirement of long-term debt	19,508,816	—
Investment in Southland Royalty Company	—	15,254,373
Net additions to other investments and other assets	491,853	346,943
Payment of cash dividends	2,074,246	2,993,086
Expenses incurred in connection with merger in 1969, treated as a pooling of interests	18,442	497,799
Increase in working capital	2,016,571	1,782,952
	$46,846,477	$44,270,742

(See accompanying notes to financial statements.)

Notes to Consolidated Financial Statements

MESA PETROLEUM CO. AND SUBSIDIARIES

(1) PRINCIPLES OF CONSOLIDATION —

The consolidated financial statements include the accounts of the parent, Mesa Petroleum Co., and its five wholly owned subsidiaries. All significant intercompany transactions have been eliminated.

The Company acquired several companies in the grain, cattle and cattle feeding business at various dates during 1969. These acquisitions were accounted for as purchases by the Company, and their operations have been included in the consolidated statements of income from their respective dates of acquisition.

(2) ACCOUNTING POLICY RELATING TO OIL AND GAS PROPERTIES AND DEPRECIATION —

The Company follows the accounting policy of capitalizing, for financial purposes, all direct costs incurred in the acquisition, exploration, and development of gas and oil reserves, including nonproductive costs. Such capitalized costs are being amortized on a company-wide composite unit-of-production method over the aggregate productive life of all of its producing properties. Under this method of accounting, no gains or losses are recognized upon the sale or disposition of oil and gas properties, except in extraordinary transactions.

Gilsonite properties, other than mine and mill equipment, are amortized on the unit-of-production method. Depreciation of mine and mill equipment, grain and cattle feeding facilities and other equipment is provided on the straight-line method of depreciation.

(3) INCOME TAXES —

Due principally to the deduction for federal income tax purposes of intangible drilling and exploration costs, statutory depletion and certain cattle inventory costs, the Company will report a loss for federal income tax purposes in 1970. This tax loss will result in a refund of approximately $2,176,000 of federal income taxes paid in 1967 by a predecessor company prior to acquisition by the Company. Approximately $2,900,000 in additional federal income taxes paid by this predecessor company in 1968 is available for refund if the Company incurs a sufficient tax loss in 1971. Any tax loss incurred in 1972 or thereafter would not result in any refund of prior taxes paid.

As of December 31, 1970, the Company has estimated unused operating loss carry-forwards of approximately $1,900,000 (expiring $780,000 in 1972 and $1,120,000 in 1973) which are available, subject to certain limitations, to reduce federal income taxes which may be payable in future periods.

Deferred taxes have been provided on accelerated depreciation of certain facilities and equipment and on certain cattle inventory costs deducted for tax purposes in excess of amounts deducted for financial reporting purposes. To the extent that the deferred taxes are attributable to current assets, the related reserve for deferred taxes is classified as a current liability. Deferred taxes applicable to intangible drilling and exploration costs, which are capitalized for financial purposes as discussed in Note (2) and are deducted as incurred for income tax purposes, will be provided for at such time as these reductions reduce the future tax deductions applicable to the Company's present oil and gas properties below the present unamortized book cost of such properties. As a result of the deduction for tax purposes of intangible drilling and exploration costs, federal income taxes have been reduced and net income has been correspondingly increased by $3,400,000 and $3,300,000 in 1970 and 1969, respectively.

(4) SHORT-TERM NOTES PAYABLE AND LONG-TERM DEBT —

Short-term notes payable as of December 31, 1970 include $2,900,000 of 7⅔% and 9% notes payable to banks which are secured by grain and cattle inventories.

Long-term debt and other obligations at December 31, 1970, and amounts due within one year are as follows:

	Long-Term	*Current*	*Total*
6½% Convertible Subordinated Debentures due 1983	$ 5,899,000	$ 250,000	$ 6,149,000
8% Secured Notes, Series "A", due 1985	13,000,000	—	13,000,000
7¾% Secured Note, Series "B", due 1975	5,500,000	—	5,500,000
Amount payable for offshore leases, financed in January, 1971 with 9¼% Secured Notes, Series "C", due 1986	7,000,000	—	7,000,000
8½% Unsecured Promissory Notes due in annual installments through January 10, 1973	976,000	2,000,000	2,976,000
Long-term bank indebtedness maturing from 1971 to 1976, and bearing interest at annual rates from 7½% to 9%	2,506,800	784,600	3,291,400
Other	293,553	425,376	718,929
	$35,175,353	$3,459,976	$38,635,329

The 6½% convertible subordinated debentures due 1983 are convertible at the option of the holder into common stock of the Company at the conversion price of $41.67 (subject to adjustment pursuant to antidilution provisions) principal amount of debentures per share.

The 8% series "A" notes due 1985 were issued to three institutional lenders, along with ten-year warrants for the purchase of 91,000 shares of common stock of the Company at $45 per share. The Company has the option to purchase the warrants at $50 per warrant at any time prior to May 31, 1979. The series "B" note due 1975, which was issued to a bank, bears interest at the rate of 1% above the bank's prime rate (7¾% at December 31, 1970). Under the mortgage indenture relating to the series "A", series "B", and series "C" notes (issued in 1971), the Company has pledged its Hugoton field oil and gas properties. The mortgage agreement stipulates that the Company maintain unconsolidated current assets in excess of unconsolidated current liabilities, as defined, and the Company may incur additional indebtedness, not junior to the mortgage notes, only under certain conditions. The mortgage agreement allows the Company, subject to certain conditions and limitations, to secure under the mortgage additional borrowings, as long as the total borrowings under the mortgage do not exceed specified percentages (ranging from 50% to 22%) of the discounted value of estimated future net revenue of the pledged properties. After giving effect to the issuance of the series "C" notes in 1971, additional borrowings of approximately $45,000,000 are presently allowable under the mortgage agreement.

In July, 1970, the Company agreed in principle with four institutional lenders to issue $10,000,000 of its 9¼% secured notes, series "C", due 1986, along with ten-year warrants for the purchase of 100,000 shares of common stock of the Company at $33 per share. The Company has the option to purchase the warrants at $50 per warrant at any time prior to September 30, 1980. The advance arrangement for these funds was necessary for the Company to participate in the Federal offshore Louisiana lease sale in December, 1970. In January, 1971, the Company issued $7,000,000 of the series "C" notes, along with warrants to purchase 70,000 shares and used the proceeds to pay for a portion of the cost of the offshore leases. It is anticipated that the Company will issue the remaining $3,000,000 of the series "C" notes, along with warrants to purchase 30,000 shares, in April, 1971.

The notes payable to banks bear interest at annual rates from 7½% to 9% and mature in varying amounts from 1971 to 1976. Under these bank loans the Company has pledged substantially all of its Canadian and U. S. (other than the Hugoton field) oil and gas properties, and has partially pledged its feedlot facilities.

(5) ANALYSIS OF COMMON AND PREFERRED STOCKS —

An analysis of the Company's common and preferred shares for the year ended December 31, 1970, is set forth below:

	Total	Common	$2.20 Senior Preferred	$2.20 Preferred
Shares outstanding, beginning of year		2,070,052	851,110	163,376
Conversion of $2.20 senior preferred stock		316,920	(169,060)	
Conversion of $2.20 preferred stock		137,937		(73,604)
Shares issued for companies acquired in 1969		5,106		
Stock options exercised		5,353		
Shares outstanding, end of year		2,535,368	682,050	89,772
Common and common equivalent shares at December 31, 1970	3,982,534	2,535,368	1,278,844	168,322

Each share of the $2.20 cumulative convertible senior preferred stock and the $2.20 cumulative convertible preferred stock is entitled to one vote per share and preferential annual cash dividends of $2.20 per share, is convertible into 1.875 shares of common stock of the Company until March 1, 1974, and 1.6 shares thereafter, is entitled to preferential payment of $75 per share on liquidation, and is redeemable at $85 per share until March 1, 1974, and $75 per share thereafter. The basic terms of the outstanding preferred shares are identical, except that the senior preferred stock has preferential rights as to dividends and distributions in liquidation.

(6) RESTRICTIONS ON PAYMENT OF DIVIDENDS —

The Company is restricted as to the payment of cash dividends under its indenture relating to the 6½% Convertible Debentures and under its mortgage agreement. At December 31, 1970, approximately $4,600,000 of reinvested earnings was not restricted as to the payment of dividends.

(7) FEDERAL POWER COMMISSION PROCEEDING —

In a proceeding before the Federal Power Commission, the Company is seeking to obtain authorization for the abandonment of sales of natural gas by Hugoton to Panhandle Eastern Pipe Line Company in the years 1961 through 1965. In April, 1969, the Commission denied the appli-

cation and ordered Hugoton to make refunds for the years 1961 and following, amounting to approximately $830,000, plus interest thereon. The maximum amount of refund including interest through December 31, 1970, net of tax effect, is estimated to be $660,000. In May, 1969, the Company applied for a rehearing of the Commission's opinion, and the application was denied on June 13, 1969. Following the denial of a rehearing by the Commission, the Company appealed the Commission's order to the United States Court of Appeals for the Fifth Circuit, challenging the lawfulness of the refunds ordered. The appeal has not yet been decided.

In prior years, a reserve for possible refunds amounting to $430,000 and the related tax benefit of $180,000 were recorded. In the Company's opinion, the reserve is adequate to cover the possible refunds under this proceeding.

(8) STOCK OPTIONS —

The 1965 and 1969 qualified stock option plans authorize the granting of options for 234,114 shares of common stock. As of December 31, 1970, options for 80,149 shares were outstanding at prices ranging from $12.40 to $46.37 per share. During the year ended December 31, 1970, options for 7,397 shares were exercised at prices ranging from $8.89 to $19.09.

On November 19, 1970, the Board of Directors of the Company adopted a non-qualified stock option program, subject to shareholder approval. The program provides for the granting of options for 100,000 shares of common stock. As of December 31, 1970, a ten-year option was granted to one officer of the Company for 7,000 shares at an exercise price of $30.57 per share.

(9) EXTRAORDINARY ITEMS —

Extraordinary items, net of tax benefits, consist of expenses associated with proposed Southland Royalty Company exchange offer ($195,201), loss on sale and abandonment of facilities ($67,331) and net gain on sale of marketable securities ($8,220).

(10) EARNINGS PER SHARE —

Earnings per share have been computed based upon the weighted average number of common shares outstanding during each period and assuming conversion of all preferred stocks, and exercise of stock options which have a dilutive effect. The 6½% convertible subordinated debentures and the warrants outstanding have not been considered in computing earnings per share as the effect of the exercise of the warrants and conversion of debentures would not be dilutive.

(11) SALE OF INVESTMENT IN SOUTHLAND ROYALTY COMPANY—

In February, 1971, the Company disposed of its investment in Southland Royalty Company for $15,273,680, which was approximately the Company's cost therein. Of the proceeds, $13,741,230 were used to retire indebtedness incurred by the Company in the acquisition of this investment. This transaction has been reflected in the accompanying financial statements as of December 31, 1970, and the excess of the proceeds received in February, 1971 over the indebtedness retired has been reflected as a receivable.

Auditors' Report

To the Stockholders and Board of Directors,

MESA PETROLEUM CO.:

We have examined the consolidated balance sheet of Mesa Petroleum Co. (a Delaware corporation) and subsidiaries as of December 31, 1970, and the related consolidated statements of income, reinvested earnings, capital surplus, and source and use of funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We have previously examined and reported on the financial statements for the preceding year.

In our opinion, the financial statements referred to above present fairly the financial position of Mesa Petroleum Co. and subsidiaries as of December 31, 1970, and the results of their operations and their source and use of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

ARTHUR ANDERSEN & CO.

Houston, Texas

February 19, 1971

James Upchurch, Frank Davis, John Boros and Jack Larsen discuss exploration and development plans for 1971.

Directors

Lester A. Anderson
John D. Kirkland*
Wales H. Madden, Jr.*
Michael A. Nicolais
T. B. Pickens, Jr.*
Richard S. Smith
Robert L. Stillwell

* Member of Executive Committee

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John F. Boros, *Secretary and Treasurer*

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Common Stock

The Chase Manhattan Bank (National Association)
The First National Bank of Amarillo

Preferred Stock

Irving Trust Company

REGISTRARS

Common Stock

Irving Trust Company
First National Bank in Dallas

Preferred Stock

The Chase Manhattan Bank (National Association)

AUDITORS

Arthur Andersen & Co.
Houston, Texas

COUNSEL

Selecman and Madden
Amarillo, Texas

Baker & Botts
Houston, Texas

OFFICES

U. S.

Vaughn Building
320 S. Polk St.
P. O. Box 2009
Amarillo, Texas 79105

The Main Building
1212 Main Street
Houston, Texas 77002

784 Lincoln Tower Building
Denver, Colorado 80203

Canada

Bradie Building
630-6th Avenue S.W.
Calgary, Alberta